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The Effect of Corruption on Foreign Direct Investments Inflows:
A Comparative Study of EU vs. Non-EU Countries

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Zusammenfassung

Ausländische Direktinvestitionen (ADI) sind ein wichtiger Motor für Wirtschaftswachstum, Technologietransfer und Produktivität, insbesondere in Volkswirtschaften im Strukturwandel. Wirtschaftliche Fundamentaldaten sind zwar bedeutsam, doch reagieren ausländische Investoren auch sensibel auf institutionelle Rahmenbedingungen. Korruption stellt dabei ein erhebliches Hindernis dar, da sie Unsicherheit, Transaktionskosten und operative Risiken erhöht. Diese Masterarbeit untersucht den Zusammenhang zwischen Korruption und ADI-Zuflüssen und legt dabei den Fokus auf Unterschiede zwischen Ländern der Europäischen Union (EU) und Nicht-EU-Ländern.

Die Studie stützt sich auf theoretische Modelle, die institutionelle Schwächen als Fixkosten für den Markteintritt in ausländische Märkte betrachten. Ein zentraler Beitrag ist die Nutzung von Unternehmenswahrnehmungen von Korruption aus der Unternehmensumfrage der Weltbank, die auf Länder- und Jahresebene aggregiert und mit makroökonomischen ADI-Daten verknüpft wurden. Dies ermöglicht eine Mikro-Makro-Perspektive, die Unternehmenserfahrungen mit nationalen Investitionsergebnissen verbindet. Panelregressionen mit festen Effekten kontrollieren für unbeobachtbare Ländereigenschaften, darunter BIP-Wachstum, Inflation, politische Stabilität und Demokratieindizes. Direktinvestitionen in unterschiedlichen regionalen und institutionellen Kontexten.

Die Ergebnisse zeigen, dass die Auswirkungen von Korruption auf ausländische Direktinvestitionen vom Kontext abhängen: In stabilen, demokratischen EU-Ländern sind sie weniger relevant, während sie in Regionen mit schwächeren Institutionen, wie etwa im Westbalkan, weiterhin abschreckend wirken. Die Ergebnisse verdeutlichen, dass für das Verständnis ausländischer Direktinvestitionen sowohl die institutionelle Qualität als auch die Kapazitäten auf Unternehmensebene berücksichtigt werden müssen. Sie liefern wichtige Erkenntnisse für politische Entscheidungsträger und multinationale Unternehmen, die in unterschiedlichen regionalen und institutionellen Kontexten Investitionen anziehen möchten.

Abstract

Foreign direct investment (FDI) is a key driver of economic growth, technology transfer, and productivity, particularly in economies undergoing structural change. While economic fundamentals are important, foreign investors are also sensitive to institutional conditions, with corruption acting as a major barrier by increasing uncertainty, transaction costs, and operational risks. This master's thesis examines the relationship between corruption and FDI inflows, focusing on differences between European Union (EU) and non-EU countries.

The study builds on theoretical models that treat institutional weaknesses as fixed costs of foreign market entry. A central contribution is the use of firm-level perceptions of corruption from the World Bank Enterprise Survey, aggregated to the country-year level and linked to macroeconomic FDI data. This enables a micro-to-macro perspective, connecting firm experiences with national investment outcomes. Fixed-effects panel regressions control for unobserved country characteristics, including GDP growth, inflation, political stability, and democracy indices.

Results indicate that the impact of corruption on FDI is context-dependent: it is less significant in stable, democratic EU countries, but remains a deterrent in regions with weaker institutions, such as the Western Balkans. The findings highlight that understanding FDI requires considering both institutional quality and firm-level capacities, providing insights for policymakers and multinational firms seeking to attract investment in diverse regional and institutional settings.

INTRODUCTION

Foreign direct investment (FDI) is widely recognized as a key driver of economic growth, industrial development, and technological innovation in both developed and emerging economies. By mobilizing capital, facilitating knowledge transfer, and integrating host countries into global value chains, FDI plays a crucial role in enhancing macroeconomic stability and international competitiveness. A country's ability to attract and sustain substantial FDI inflows depends not only on traditional economic factors such as market size, labor costs, and infrastructure quality but also, importantly, on the strength of its institutional frameworks and governance. In this institutional context, corruption is a significant impediment, undermining investment attractiveness and compromising the effectiveness of economic development efforts. Corruption, broadly defined as the misuse of public office for private gain, distorts market mechanisms, increases transaction costs, and erodes investor confidence. It weakens the rule of law, undermines contract enforcement, and creates an unpredictable regulatory environment that deters long-term investment. As multinational enterprises (MNEs) seek to maximize returns while minimizing risks, the presence of corruption in a host country becomes a significant factor in their decision-making. While some firms may attempt to navigate or adapt to corrupt environments, most view corruption as a source of institutional uncertainty and reputational risk that can jeopardize the viability of investment projects.

Despite the extensive academic attention given to corruption's effects on FDI, empirical evidence remains mixed and context-dependent. On one hand, corruption is widely regarded as a deterrent to foreign investment because it introduces uncertainty, increases operational costs, and compromises legal enforceability (Habib & Zurawicki, 2002; Egger & Winner, 2005). On the other hand, some studies suggest that in countries with weak institutions, corruption may function as a "grease the wheels" mechanism that helps firms navigate inefficient bureaucracies, thereby occasionally facilitating investment (Leff, 1964; Méon & Sekkat, 2005). These divergent findings highlight the importance of accounting for the broader institutional environment and sectoral differences when examining corruption's impact on FDI (Cuervo-Cazurra, 2006; Bevan & Estrin, 2004).

This thesis contributes to this literature by conducting a comparative analysis of country-level corruption's influence on firm-level FDI in European Union (EU) member states versus non-EU countries. The EU represents a unique institutional setting characterized by harmonized regulatory frameworks, supranational oversight, and relatively robust anti-corruption mechanisms (European Commission, 2020). These factors typically result in higher institutional quality, transparency, and predictability, thereby potentially mitigating the negative effects of corruption on foreign investment (Egger & Winner, 2005). Conversely, many non-EU countries, particularly emerging markets and developing economies, face systemic corruption, weaker rule of law, and political instability, which amplify risks for foreign investors and often result in lower FDI attractiveness (Busse & Hefeker, 2007). By contrasting these two groups of countries, this study aims to explore how differences in institutional quality and governance shape the corruption-FDI relationship.

Moreover, the thesis examines the moderating roles of political stability and democratic governance, which recent research identifies as critical contextual factors influencing the effect of corruption on FDI. Political stability reduces investment uncertainty and risk, which can partially offset the detrimental consequences of corruption (Le et al., 2023). Likewise, democratic institutions enhance transparency, strengthen the rule of law, and promote accountability among public officials, thereby mitigating corruption and fostering a more favorable investment climate (Ades & Di Tella, 1999; Mauro, 1995; Svensson, 2005). Empirical studies show that democracies tend to provide more predictable and stable environments for foreign investors by reducing arbitrary governance and improving institutional quality (Adsera, Boix, & Payne, 2003). However, empirical research on these moderating effects remains limited, especially in the comparative context of EU versus non-EU countries. This thesis addresses this gap by empirically testing whether political stability and democracy reduce the negative impact of country-level corruption on firm-level FDI across diverse institutional environments. Furthermore, this analysis highlights policy implications. Improving governance and reducing corruption could increase the likelihood that domestic firms attract foreign investment, indicating that anti-corruption reforms enhance both fairness and economic competitiveness. Additionally,

this firm-level approach contributes to the literature by demonstrating heterogeneity in investment responses that aggregate country-level FDI studies cannot capture.

This study demonstrates that country-level corruption affects the likelihood of firm-level foreign direct investment (FDI), but its effects are highly context-dependent and shaped by institutional and firm-level factors. Using a large sample of 43,378 firm-level observations across 31 countries, the analysis shows that firm characteristics consistently play a key role: larger firms and exporters are significantly more likely to attract foreign investment, while older firms are slightly less likely to receive FDI. At the country level, corruption alone does not significantly reduce FDI in the full sample or EU countries once political stability and democracy are included, indicating that broader institutional quality shapes how corruption affects investment decisions. However, corruption remains a significant deterrent in Latin America, highlighting regional heterogeneity in how institutional weaknesses influence foreign investment. Political stability exhibits region-specific effects: it strongly promotes FDI in Latin America, is unexpectedly negatively associated with FDI in the Western Balkans, and is insignificant in the EU, underscoring the context-dependent role of stability. Democracy shows a positive effect in the full sample but is not significant in regional subsamples, suggesting that democratic institutions can support investment in diverse environments but do not uniformly determine FDI patterns.

These findings highlight the complex interplay between firm characteristics, corruption, and institutional quality in shaping foreign investment. The study contributes to the literature in several ways. First, it provides a nuanced understanding of how institutional heterogeneity between EU and non-EU countries shapes the relationship between corruption and firm-level FDI, moving beyond aggregate cross-country analyses. Second, by integrating political stability and democratic governance, it offers a more comprehensive framework for analyzing institutional determinants of FDI. Third, employing logistic regression with country and year fixed effects on a large multi-country dataset enables robust empirical inference while controlling for unobserved heterogeneity and year-specific shocks. Overall, the results suggest important policy implications: improving governance and strengthening democratic and political institutions can enhance countries' attractiveness to foreign investors, while firm-level factors such as size and international engagement remain critical determinants of foreign ownership.

In summary, this thesis addresses the following research questions: (1) How does country-level corruption affect firm-level FDI in EU versus non-EU countries? (2) To what extent do political stability and democratic governance impact firm-level FDI? And (3) What policy measures can effectively mitigate corruption's adverse effects to foster a more conducive environment for foreign investment? The answers to these questions will contribute to academic discussion and practical policymaking, ultimately supporting sustainable economic development in an increasingly interconnected global economy.

1. LITERATURE REVIEW

FDI plays a central role in global economic integration, serving as a key driver of technology transfer, job creation, and the expansion of domestic industries. In recent decades, growing academic attention has increasingly focused on the institutional determinants of FDI, with particular emphasis on corruption and its influence on the investment strategies of multinational enterprises (MNEs). The World Bank defines corruption as “*the abuse of public office for private gain*” (World Bank, 1997). This concise definition has become a standard reference in economics, political science, and international business research. Corruption includes practices such as bribery, fraud, embezzlement, favoritism, nepotism, and abuse of authority (Bahoo et al., 2020; Transparency International, 2023). Economically, corruption is a distortionary factor that disrupts market functioning, increases transaction costs, and undermines institutional trust. Furthermore, corruption is widely recognized as one of the most significant non-market barriers to foreign investment, as it heightens uncertainty, distorts market competition, raises the economic costs of business activities, and erodes the reliability of contract enforcement. However, the magnitude and direction of its impact on FDI vary considerably across countries and regions, reflecting differences in institutional frameworks, sectoral composition of investment, and the geographical origins of investors. This literature review examines the complex relationship between corruption and FDI by integrating theoretical insights with empirical evidence. It places particular emphasis on comparative patterns between European and non-European contexts, addressing both the macro-level, where corruption shapes aggregate country attractiveness to FDI, and the micro-level, where firm-specific characteristics and strategies determine how enterprises perceive and respond to corrupt environments.

1.1. Macro-level perspective: Corruption and FDI at the country level

Empirical evidence overwhelmingly indicates that corruption constrains FDI, particularly in jurisdictions with fragile legal institutions and weak enforcement of property rights. Mauro’s (1995) seminal study demonstrated that corruption has a significant negative effect on both investment levels and economic growth. Building on this institutional perspective, North (1990) and Williamson (2000) highlight the centrality of institutional quality in determining economic performance. In environments where enforcement mechanisms are unreliable, corruption erodes transparency and predictability, both essential for attracting foreign capital.

However, the effect of corruption on FDI is not uniformly negative across all contexts. In several Central and Eastern European (CEE) economies, persistent corruption has coincided with substantial FDI inflows, attributable to offsetting advantages such as low labor costs and strategic geographic positioning (Bevan & Estrin, 2004). Nonetheless, corruption undermines the enforceability of legal agreements and exposes firms to reputational and compliance risks, particularly under the constraints of international anti-corruption regimes. Although the “grease the wheels” hypothesis suggests that corruption may, in certain circumstances, facilitate

investment by enabling firms to circumvent bureaucratic inefficiencies (Leff, 1964; Huntington, 1968), the prevailing empirical evidence largely supports the “sand the wheels” perspective, which conceptualizes corruption as a fundamental barrier to sustainable and efficiency-enhancing FDI (Mauro, 1995; Habib & Zurawicki, 2002; Bevan & Estrin, 2004).

Empirical studies in various contexts consistently find that corruption negatively impacts FDI inflows. Wei (2000) presents one of the earliest and most influential empirical analyses, showing that corruption acts like a tax on foreign investors and significantly reduces their willingness to enter corrupt markets. Busse and Hefeker (2007) support this conclusion, identifying corruption as a key factor within broader institutional and political risk assessments that affect investment decisions. Mauro (1995) - finds that corruption reduces investment by introducing uncertainty and increasing the cost of doing business. Smarzynska and Wei (2000) show that corruption not only reduces the volume of FDI but also influences the composition of investment, discouraging greenfield projects and wholly owned subsidiaries in favor of joint ventures or portfolio investments that involve less exposure to corrupt practices.

The role of host-country institutions is also emphasized in theoretical models of FDI. The framework by Helpman, Melitz, and Yeaple (2004) illustrates that firms with higher productivity are more likely to engage in FDI, but only if the institutional environment ensures predictable returns. In corrupt contexts, the cost-benefit analysis changes, reducing the likelihood that even productive firms will commit to foreign investment. According to Kaufmann and Wei (1999) – argue that corruption acts as a “regulatory tax” that reduces the transparency and predictability of administrative processes, making long-term planning difficult for investors. Cuervo-Cazurra (2006) suggests that firms from corrupt home countries are less sensitive to host-country corruption, while Javorcik and Wei (2009) find that corruption deters efficiency-seeking and export-oriented FDI more than resource-seeking investment.

An increasing number of studies further differentiate between various forms of foreign direct investment when examining the impact of corruption. Greenfield investment, which involves establishing new production facilities, is particularly vulnerable to corruption due to the need for permits, licenses, and direct interaction with public authorities. Voyer and Beamish (2004) and Al-Sadig (2009) argue that corruption significantly increases the cost and risk associated with greenfield projects, thereby deterring such investments. In contrast, mergers and acquisitions (M&A) may be less affected, as they allow firms to partner with or acquire existing local entities that already possess the institutional know-how and networks to navigate corrupt systems. Consequently, in highly corrupt environments, foreign investors may prefer M&A or joint ventures over wholly owned greenfield investments.

Several studies have explored regional differences in the corruption-FDI relationship. In European countries, strong institutional frameworks, legal protections, and low tolerance for corruption help mitigate its adverse effects on investment (Egger & Winner, 2005). Conversely,

in non-European countries, particularly in Sub-Saharan Africa, South Asia, and Latin America, corruption is often systemic, and the absence of effective enforcement mechanisms significantly heightens investor risk (Busse & Hefeker, 2007). Campos, Lien, and Pradhan (1999) suggest that in environments where corruption is predictable and institutionalized, firms may adjust and incorporate bribery into their cost structure. However, this does not imply neutrality, as it tends to divert investment towards rent-seeking sectors and away from productive long-term projects.

In Western European countries, where governance structures are relatively strong, corruption tends to have a more limited and indirect effect on FDI patterns. However, in Central and Eastern Europe corruption remains a significant deterrent to foreign investment. Bevan and Estrin (2004) find that higher perceived corruption in Eastern European countries significantly reduces the attractiveness of these locations to Western European investors. Campos, Lien, and Pradhan (1999) argue that institutional reforms and efforts to reduce corruption were critical to the surge in FDI during the 1990s in Central Europe. Similarly, Kinoshita and Campos (2003) show that investor interest in EU candidate countries increased alongside improvements in governance and anti-corruption measures. The conditionality mechanisms embedded in the European Union's accession process created strong incentives for institutional convergence and transparency, thereby enhancing investor confidence.

Recent studies emphasize that the relationship between foreign direct investment (FDI) and corruption is significantly influenced by broader institutional and contextual factors. Institutional quality, including the strength of governance frameworks and the rule of law, plays a critical role in shaping how corruption affects FDI inflows. For instance, Asiedu and Lien (2011) demonstrate that in countries with robust legal institutions and transparent governance, corruption tends to deter FDI more strongly, as investors are less willing to bear the costs and risks associated with corrupt practices. Conversely, in countries with weaker institutional structures, firms may tolerate or adapt to corruption, viewing it as a transactional cost or a mechanism to "grease the wheels" of bureaucratic inefficiency (Iorio & Segnana, 2025). This institutional heterogeneity explains the divergent empirical findings across regions and sectors, underscoring the importance of accounting for governance quality when analyzing the corruption-FDI relationship.

Recent empirical studies consistently find that corruption significantly deters FDI inflows by increasing uncertainty, raising transaction costs, and undermining institutional trust. For example, a comprehensive study on Ghana using the Autoregressive Distributed Lag (ARDL) Bounds testing model demonstrated that corruption negatively affects FDI inflows, supporting the "grabbing hand" hypothesis that corruption imposes additional costs on foreign investors (Owusu, 2023). Similarly, in Jordan, research indicates that while corruption hampers FDI, improvements in institutional quality can mitigate these adverse effects, highlighting the conditional nature of corruption's impact (Alkhalidi & Al Khafaji, 2020). These findings

underscore the importance of transparent and effective governance structures in attracting and sustaining foreign investment.

Schneider, Matei, and Sattar (2022) reassess the relationship between corruption and FDI by examining the role of financial development across 80 countries. Using panel smooth transition regression (PSTR) models for the period 2003–2019, the authors find a non-linear link between corruption and FDI. In advanced economies, lower levels of corruption are associated with higher FDI, but only above a certain corruption threshold. In contrast, emerging economies appear more tolerant of corruption, and the positive effects of financial institutions on FDI are stronger in these countries than in advanced economies.

Abosti (2016) presents a theoretical analysis suggesting that corruption is an inevitable feature of developing countries. Drawing on firm optimization theory, he argues that corruption can have a positive effect on foreign direct investment when institutional quality is high, but a negative effect when institutional quality is low. This study describes this inflection point as the “corruption-tolerable level of investment.” Furthermore, Bahoo et al. (2020) systematically reviewed 137 articles on corruption in international business published between 1992 and 2019, identifying seven main research streams, including anti-corruption legislation, determinants of corruption, firm-level impacts, and effects on FDI and trade. Their findings highlight the importance of strong international regulations to mitigate corruption’s negative effects and emphasize that firms should incorporate corruption considerations into strategic planning to enhance efficiency and performance. The study also notes that corruption challenges existing management theories, suggesting the need to adapt these frameworks to account for corrupt environments.

1.2. Micro-level perspective: Corruption and FDI at the firm level

At the micro level, studies examine how individual MNEs experience and adapt to corruption when making FDI decisions. Specifically, firm-level characteristics such as size, ownership structure, international experience, and profitability strongly influence how companies respond (Roy & Oliver, 2009; Chen et al., 2010). While some firms avoid corrupt countries, others adapt by developing capabilities that enable them to operate effectively in such environments (Thede & Karpaty, 2023). This has prompted debate on whether corruption hinders investment by creating obstacles and costs or, under certain institutional conditions, can actually facilitate investment (Driffield et al., 2013; Abotsi, 2016). Overall, the micro-level perspective highlights the heterogeneity of firm responses, showing that corruption does not deter all firms equally and depends on their resources, strategies, and prior exposure.

Thede and Karpaty (2023) provide empirical evidence on how MNEs adapt to corrupt institutional environments. Using data on Swedish manufacturing firms’ international activities

from 1997 to 2015, the study examines whether prior experience in highly corrupt countries reduces the entry barriers typically associated with corruption. Employing a mixed logit model that accounts for firm-specific market substitution patterns, the authors find that although corruption generally deters foreign market entry (Habib & Zurawicki, 2002), firms with prior exposure to corrupt environments are less affected. This indicates that MNEs can develop adaptive capabilities that mitigate the costs of operating in corrupt contexts, providing a competitive advantage over less experienced firms.

Luo (2006) suggests that in highly corrupt host countries, firms with political connections and limited ethical constraints are more likely to engage in bribery. Similarly, the performance of mergers and acquisitions (M&A) by politically connected firms tends to be weaker in countries with lower levels of corruption. Evidence also indicates that politically connected firms operating in corrupt environments issue fewer earnings forecasts (Hung et al., 2018). In contrast, Yim et al. (2017) argue that political connections can be beneficial, as lobbying activities may yield more positive outcomes than direct bribery.

Viglioni et al. (2021) found that corruption has a direct and positive impact on firms' financial performance. However, while firm performance tends to improve in corrupt environments, their results also indicate that corruption weakens the positive relationship between R&D investments and financial outcomes. This evidence challenges the idea that corruption facilitates business operations, suggesting instead that it acts as an obstacle, particularly for firms engaged in innovation. Furthermore, the study revealed that long-term R&D investments have a negative effect on firm performance under high levels of corruption, emphasizing the harmful influence of corruption on sustained innovative activities. The analysis used dynamic panel data for local private and public firms in Latin American countries (Brazil, Chile, Mexico, and Peru) during 2012–2019, applying the generalized method of moments (GMM) and instrumental variables (IV) techniques to address potential endogeneity issues.

Akron et al. (2023) examine how economic uncertainty moderates the relationship between corruption and firm-level investment. Using a dataset of firms from 30 European countries over 2011–2020, the study identifies a direct negative effect of both economic uncertainty and corruption on firms' capital expenditures. However, the results reveal a significant positive moderating effect, indicating that higher economic uncertainty amplifies the negative impact of corruption on corporate investment. These findings, which remain robust after controlling for country, industry, and time fixed effects, provide valuable insights into how the interaction between corruption and uncertainty shapes investment behavior and may help explain variations in growth patterns across countries.

Integrating both micro- and macro-perspectives provides a comprehensive understanding of the corruption-FDI relationship. The macro approach reveals the general pattern that corruption reduces FDI inflows at the national level, while the micro perspective uncovers firm-level

heterogeneity, showing that not all firms are equally deterred. Some firms adapt to or exploit corrupt environments depending on their strategic capabilities. Building on this integration, this study focuses on firm-level FDI decisions across European and non-European contexts, examining how political stability and democratic governance moderate the relationship between country-level corruption and firm-level investment behavior.

Despite substantial progress in understanding how corruption affects FDI, several research gaps remain. Most empirical studies rely on macro-level data, leaving firm-level decision-making processes underexplored. Furthermore, the temporal dynamics of how FDI patterns change in response to anti-corruption reforms are not sufficiently studied. Subnational variations in corruption within large, federal states such as Russia, India, or Brazil also warrant deeper investigation, given their potential to influence location-specific investment decisions. In addition, the growing importance of environmental, social, and governance (ESG) criteria in investment decisions introduces new dimensions to the study of corruption, as firms increasingly face reputational and regulatory pressure to avoid involvement in corrupt environments. Therefore, a deeper understanding of how political stability and democratic governance interact with corruption to influence firm-level FDI is essential for developing more targeted and effective investment policies. However, existing studies have yet to empirically demonstrate how political stability and the level of democracy influence the relationship between corruption and FDI. This thesis addresses this gap by providing empirical evidence on the moderating effects of political stability and democratic governance on the corruption-FDI relationship.

2. HYPOTHESES DEVELOPMENT

Corruption has been widely recognized as a critical barrier to FDI, fundamentally shaping how MNEs perceive and evaluate host-country environments. By increasing transaction costs, creating uncertainty, and eroding institutional trust, corruption influences both investor risk assessments and entry decisions (Chen et al., 2010; Driffield et al., 2013; Hung et al., 2018; Luo, 2006; Roy & Oliver, 2009; Thede & Karpaty, 2023). While previous research has underscored the country-level determinants of corruption and its macroeconomic consequences, increasing attention is being paid to firm-level heterogeneity in responses to corrupt environments. This line of inquiry emphasizes that the impact of corruption on firm-level FDI cannot be fully understood without considering firm-specific characteristics that shape firms' ability to operate in different institutional contexts. In particular, firm size, exporter status, age, and sectoral affiliation play a central role in mediating investment outcomes. Larger firms and exporters, with greater financial resources, managerial capacity, and international experience, are better equipped to navigate institutional imperfections and regulatory complexity, thereby reducing the effective costs of corruption. In contrast, older firms less likely to have foreign ownership, potentially reflecting organizational rigidity or reduced growth orientation. By explicitly incorporating these micro-level characteristics alongside country-level institutional indicators, the model captures how firm

capabilities interact with governance conditions to influence FDI decisions, providing a more nuanced understanding of how corruption affects foreign investment at the firm level. Building on this perspective, the following hypotheses aim to clarify how corruption affects firm-level FDI and whether political stability and the level of democracy in the host country mitigate this relationship.

The comparative perspective between European and non-European countries highlights significant institutional and contextual differences. European Union countries, particularly those in Western and Northern Europe, benefit from harmonized regulations, transparent legal systems, and supranational oversight mechanisms, whereas many non-European countries lack these institutional safeguards. This institutional divergence results in greater investor sensitivity to corruption in non-European contexts. However, within Europe, corruption continues to influence FDI flows, especially in Southeastern Europe and the Western Balkans, where governance reforms are still incomplete. Based on this institutional heterogeneity, the following directional hypothesis is proposed to examine the effect of corruption on firm-level FDI across European and non-European countries:

H₁: Higher levels of country-level corruption are associated with lower firm-level FDI.

Moreover, recent literature has not yet fully explored how political stability influences the effect of corruption on FDI. While political stability is widely recognized for reducing investment risks and creating a more predictable business environment, its role as a moderator in the corruption-FDI relationship remains underexamined, particularly in both European and non-European contexts. Empirical studies from emerging Asian economies indicate that political stability significantly enhances FDI inflows by fostering a secure and stable investment climate (Le et al., 2023). In addition to political stability, democratic governance contributes to greater transparency, accountability, and adherence to the rule of law, which together mitigate the adverse effects of corruption on FDI. These institutional factors highlight that the impact of corruption cannot be fully understood without considering the broader political and governance context. Building on this gap, this thesis proposes the following hypothesis:

H₂: Higher levels of political stability are associated with higher firm-level FDI.

The impact of corruption cannot be fully understood without considering the broader political and institutional context in which it occurs. The complex interplay between corruption, political stability, and democracy further indicates that effective policy interventions to attract FDI must be multifaceted. Countries plagued by weak institutions and systemic corruption are unlikely to attract sustainable FDI if political instability and autocratic governance persist. In contrast, strengthening democratic processes and ensuring political stability can create a more favorable investment climate, even when corruption remains. These insights underscore the necessity of comprehensive reform strategies that go beyond anti-corruption efforts to include enhancing

democratic governance and ensuring political stability, thereby cultivating a more favorable environment for sustainable FDI inflows and long-term economic development (Busse & Hefeker, 2007; Javorcik & Wei, 2009). Based on these statements, the following hypothesis is proposed:

H₃: Higher levels of democracy are associated with higher firm-level FDI.

In summary, these hypotheses aim to capture both the direct and conditional effects of country-level corruption on firm-level FDI. The first hypothesis establishes the expected negative impact of corruption on foreign investment decisions, while the second and third highlight the importance of institutional moderators, namely political stability and democracy, which may weaken or alter this relationship. This integrated framework allows us to test not only whether corruption deters FDI, but also under which conditions its adverse effects may be mitigated, providing a more nuanced understanding of how firms respond to institutional environments across countries.

3. RESEARCH METHODOLOGY

Estimating the effect of country-level corruption on firm-level FDI enables us to assess whether corruption deters or attracts foreign investors at the micro level. Specifically, we seek to determine whether firms in more corrupt countries are less likely to receive foreign investment, thereby linking the quality of national institutions to firm-level investment outcomes. We also examine how the institutional context moderates this relationship. Political stability and democracy may either moderate or amplify the effects of corruption on FDI. In stable democracies, investors may be more willing to tolerate certain levels of corruption, whereas in fragile autocracies, corruption is likely to act as a stronger deterrent to foreign investment. Firm-level characteristics such as size, export status, and age may also influence sensitivity to corruption.

3.1. Empirical model

To empirically examine the effect of corruption on FDI in European and non-European countries, and to assess the moderating effects of political stability and democratic governance on the relationship between corruption and FDI inflows, a fixed-effects logistic regression model is employed:

$$FDI_{j,i,t} = \alpha + \beta_1 \cdot Corruption_{i,t} + \beta_2 \cdot Political_stability_{i,t} + \beta_3 \cdot Democracy_{i,t} + \left(\sum_{k=4}^l \beta_k \cdot Firm_Level_Micro_Controls_{k,t} \right) + \left(\sum_{m=l+1}^n \beta_g \cdot Country_Level_Macro_Controls_{k,t} \right) + \beta_s \cdot COUNTRY_FIXED_EFFECTS + \beta_u \cdot YEAR_FIXED_EFFECTS + \varepsilon_{j,i,t} \quad (1)$$

where index j refers to the firm, i to the country, and t to the time period.

FDI_{i,t} is the dependent variable representing the foreign ownership of firm j in country i at time t , measured as a dummy variable equal to one if the firm has any foreign ownership, or as the share of the firm owned by foreign investors.

Corruption_{i,t} represents variable on interest, measured using the Control of Corruption index from the Worldwide Governance Indicators (WGI), which reflects perceptions of corruption within the public sector on a standardized scale.

Political_stability_{i,t} is also derived from the WGI, capturing the likelihood of political unrest or politically motivated violence that could disrupt governance and investment climates.

Democracy_{i,t} is measured using the Polity IV dataset's democracy score, which assesses the degree of democratic characteristics in governance structures.

X_{j,i,t} is a vector of firm control variables (**firm size, firm age, exporter status, sector, corruption_obstracle**). **Y_{i,t}** presents country-level macro controls (**GDP per capita (log), Trade openness, Region indicator**). The interaction terms test the hypotheses that political stability and democracy moderate the negative effect of corruption on FDI. **Country fixed effects (μ_i)** control for time-invariant characteristics, while **year fixed effects (η_t)** account for global shocks or trends affecting all countries. **Firm fixed effects (λ_j)** control for all unobserved, time-invariant characteristics of firms, ensuring that our estimates reflect only within-firm variation over time.

Firm-level micro controls (X variables)

At the firm level, the model includes five key control variables that capture fundamental characteristics affecting FDI.

X₁ – Firm size (ln_employees_{j,i,t}) accounts for the scale of the firm, with larger firms generally better positioned to attract foreign investment.

X₂ – Exporter status (Exporter_{j,i,t}) is a dummy variable indicating whether a firm engages in international trade, reflecting its integration into global markets and potential attractiveness to foreign investors.

X₃ – Firm age (ln_age_{j,i,t}) captures the experience and stability of the firm, with older firms often having established networks and operational track records that facilitate FDI.

X₄ – Sector (Sector_{j,i,t}) is included as a dummy variable that takes the value 1 if a firm operates in the manufacturing sector, and 0 if it operates in the services sector.

X₅ – Corruption obstacle (Corruption_obstacle_{j,i,t}) presents the perception of corruption as an obstacle, measures the subjective assessment of business entities regarding the extent to which corruption hinders or limits their operations.

Country-level macro controls (Y variables)

The model further includes three key country-level control variables that vary over time.

Y₁ – GDP per capita (log) (logGDP_PC_{it}) captures the income level and market size of a country, with higher values indicating wealthier and larger markets that are more likely to attract foreign direct investment.

Y₂ – Trade openness (Trade_open_{i,t}), measured as the sum of exports and imports relative to GDP, reflects the degree of a country's integration into the global economy, facilitating cross-border investment and lowering barriers for foreign firms.

Y₃ – Region indicator (Region_{i,t}) is included as a dummy variable equal to 1 if a country is EU member, and 0 otherwise. These variables help isolate the effect of corruption, political stability, and democracy on firm-level FDI outcomes.

3.2. Data and descriptive statistics

The analysis uses an unbalanced panel dataset covering 31 countries with firm-level observations from selected years between 2009 and 2024. Country-level variables, including GDP per capita, trade openness, and regional membership, are sourced from reputable international databases such as the World Bank's World Development Indicators (WDI). Firm-level characteristics, such as firm size, age, export status, foreign ownership, and corruption obstacles, are obtained from the World Bank Enterprise Surveys (WBES). The Control of Corruption index, which captures perceptions of public sector corruption, and political stability are both collected from the Worldwide Governance Indicators (WGI). Democracy scores, reflecting the level of democratic governance in each country, are retrieved from the Polity V dataset. Additionally, data from Transparency International's Corruption Perceptions Index (CPI) supplement the corruption measure where relevant. The combination of firm-level and country-level variables enables for a comprehensive investigation of how institutional factors, including corruption, political stability, and democracy, influence FDI at the firm level, while controlling for both firm-specific and country-specific characteristics.

To ensure meaningful comparison between European Union (EU) and non-EU contexts, it is important to include non-EU countries that reflect variation in corruption levels, institutional quality, and attractiveness for FDI. Within Europe, the Western Balkans (e.g., Albania, Bosnia and Herzegovina, Serbia, Montenegro, and North Macedonia) provide useful contrasts as transition economies with persistent corruption challenges but increasing integration into

international markets. Beyond Europe, countries in Latin America (e.g., Brazil, Mexico, and Chile) offer valuable comparative cases. These are major recipients of FDI, yet they differ significantly in institutional stability and exposure to corruption. Brazil and Mexico are characterized by relatively high corruption and political risks, while Chile is often regarded as one of the region's more stable and transparent economies. Including such countries alongside European cases enables assessment of whether the corruption-FDI relationship and the roles of democracy and political stability are region-specific or apply more broadly across diverse institutional environments. Furthermore, this combination allows for testing whether corruption affects FDI differently in emerging versus advanced economies within Europe.

In summary, as the study examines European and non-European countries to analyze firm-level FDI in relation to country-level corruption, political stability, and democracy, the sample includes the following countries: Albania, Austria, Belgium, Bulgaria, Bosnia and Herzegovina, Brazil, Chile, Cyprus, Czech Republic, Germany, Spain, Estonia, France, Greece, Croatia, Hungary, Ireland, Italy, Lithuania, Latvia, Mexico, North Macedonia, Malta, Montenegro, Poland, Portugal, Romania, Serbia, Slovakia, Slovenia, and Sweden.

Table 1 shows the country-year distribution of firm-level observations used in the analysis. The dataset comprises 43,378 observations from 31 countries covering the years 2009 to 2024. The panel is unbalanced, as not all countries are observed in every year, due to differences in survey timing and data availability. The largest numbers of observations are recorded in 2019 and 2023, while earlier years such as 2010 and 2014 are represented by fewer countries. Several countries including Romania, Mexico, Poland, and Hungary, account for a substantial share of the sample, whereas others appear only in selected years. Table 1 provides a country–year cross-tabulation that illustrates the structure of the matched dataset used in the analysis. This table is important because it reflects the integration of **micro-level firm data** with **macro-level country indicators**, creating a unique matched dataset that links firm-level investment outcomes to country-level institutional conditions. By combining observations across firms, countries, and years, the table highlights the unbalanced nature of the panel and the heterogeneity in country-year coverage. This integrated structure enables the analysis to capture how firm-level foreign direct investment decisions are shaped by broader institutional and economic environments. The resulting matched dataset provides rich and novel information, allowing for a more nuanced examination of FDI determinants that cannot be obtained from purely firm-level or country-level data alone, thereby significantly enhancing the empirical contribution of the study.

Table 1. Distribution of observations by country and year

		Year									Total
		2009	2010	2013	2014	2018	2019	2021	2023	2024	
Country	1 ALB	0	0	360	0	0	377	0	0	0	737

2 AUT	0	0	0	0	0	0	600	0	0	600
3 BEL	0	0	0	0	0	0	0	0	320	320
4 BGR	288	0	293	0	0	772	0	710	0	2063
5 BIH	361	0	360	0	0	362	0	351	0	1434
6 BRA	1802	0	0	0	0	0	0	0	0	1802
7 CHL	0	1033	0	0	0	0	0	0	0	1033
8 CYP	0	0	0	0	0	240	0	0	246	486
9 CZE	0	0	0	0	0	0	0	0	268	268
10 DEU	0	0	0	0	0	0	1694	0	0	1694
11 ESP	0	0	0	0	0	0	1051	0	1412	2463
12 EST	273	0	273	0	0	360	0	351	0	1257
13 FRA	0	0	0	0	0	0	1566	0	0	1566
14 GRC	0	0	0	0	600	0	0	598	0	1198
15 HRV	0	0	360	0	0	404	0	474	0	1238
16 HUN	291	0	310	0	0	805	0	831	0	2237
17 IRL	0	0	0	0	0	0	0	0	609	609
18 ITA	0	0	0	0	0	760	0	0	1216	1976
19 LTU	276	0	270	0	0	358	0	0	0	904
20 LVA	271	0	336	0	0	359	0	0	360	1326
21 MEX	0	1480	0	0	0	0	0	1322	0	2802
22 MKD	366	0	360	0	0	360	0	354	0	1440
23 MLT	0	0	0	0	0	242	0	0	241	483
24 MNE	116	0	150	0	0	150	0	151	0	567

25 POL	455	0	542	0	0	1369	0	0	0	2366
26 PRT	0	0	0	0	0	1062	0	1007	0	2069
27 ROM	541	0	540	0	0	814	0	942	0	2837
28 SRB	388	0	360	0	0	361	0	0	502	1611
29 SVK	275	0	268	0	0	429	0	464	0	1436
30 SVN	276	0	270	0	0	409	0	0	402	1357
31 SWE	0	0	0	600	0	0	0	0	599	1199
Total	5979	2513	5052	600	600	9993	4911	7555	6175	43378

Table 2 shows the frequency distribution of observations by country. The full sample comprises 43,378 firm-level observations across 31 countries. The largest shares of observations are from Romania (6.5%), Mexico (6.5%), Spain (5.7%), Poland (5.5%), and Hungary (5.2%). Several countries, including Germany, Italy, Portugal, Bulgaria, and Brazil, also contribute substantial portions of the sample, each accounting for between 3 and 5 percent of total observations. Overall, no single country dominates the dataset, supporting the use of country fixed effects in the empirical analysis.

Table 2. Frequency of observations by country

		<i>Frequency</i>	<i>Percent</i>	<i>Valid Percent</i>	<i>Cumulative Percent</i>
Valid	1 ALB	737	1.7	1.7	1.7
	2 AUT	600	1.4	1.4	3.1
	3 BEL	320	0.7	0.7	3.8
	4 BGR	2063	4.8	4.8	8.6
	5 BIH	1434	3.3	3.3	11.9
	6 BRA	1802	4.2	4.2	16.0
	7 CHL	1033	2.4	2.4	18.4
	8 CYP	486	1.1	1.1	19.5

9 CZE	268	0.6	0.6	20.2
10 DEU	1694	3.9	3.9	24.1
11 ESP	2463	5.7	5.7	29.7
12 EST	1257	2.9	2.9	32.6
13 FRA	1566	3.6	3.6	36.2
14 GRC	1198	2.8	2.8	39.0
15 HRV	1238	2.9	2.9	41.9
16 HUN	2237	5.2	5.2	47.0
17 IRL	609	1.4	1.4	48.4
18 ITA	1976	4.6	4.6	53.0
19 LTU	904	2.1	2.1	55.1
20 LVA	1326	3.1	3.1	58.1
21 MEX	2802	6.5	6.5	64.6
22 MKD	1440	3.3	3.3	67.9
23 MLT	483	1.1	1.1	69.0
24 MNE	567	1.3	1.3	70.3
25 POL	2366	5.5	5.5	75.8
26 PRT	2069	4.8	4.8	80.5
27 ROM	2837	6.5	6.5	87.1
28 SRB	1611	3.7	3.7	90.8
29 SVK	1436	3.3	3.3	94.1
30 SVN	1357	3.1	3.1	97.2
31 SWE	1199	2.8	2.8	100.0

<i>Total</i>	<i>43378</i>	<i>100.0</i>	<i>100.0</i>
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Table 3 shows the frequency distribution of observations by year. The sample comprises 43,378 firm-level observations collected from 2009 to 2024. Observations are unevenly distributed across years, reflecting the timing of data collection. The largest proportion of observations was recorded in 2019, accounting for 23.0 percent of the total sample, followed by 2023 (17.4 percent) and 2024 (14.2 percent). Earlier years, such as 2010, 2014, and 2018, contribute relatively fewer observations. This uneven temporal distribution supports the inclusion of year fixed effects in the empirical analysis.

Table 3. Frequency of observations by year

		<i>Frequency</i>	<i>Percent</i>	<i>Valid Percent</i>	<i>Cumulative Percent</i>
<i>Valid</i>	<i>2009</i>	<i>5979</i>	<i>13.8</i>	<i>13.8</i>	<i>13.8</i>
	<i>2010</i>	<i>2513</i>	<i>5.8</i>	<i>5.8</i>	<i>19.6</i>
	<i>2013</i>	<i>5052</i>	<i>11.6</i>	<i>11.6</i>	<i>31.2</i>
	<i>2014</i>	<i>600</i>	<i>1.4</i>	<i>1.4</i>	<i>32.6</i>
	<i>2018</i>	<i>600</i>	<i>1.4</i>	<i>1.4</i>	<i>34.0</i>
	<i>2019</i>	<i>9993</i>	<i>23.0</i>	<i>23.0</i>	<i>57.0</i>
	<i>2021</i>	<i>4911</i>	<i>11.3</i>	<i>11.3</i>	<i>68.3</i>
	<i>2023</i>	<i>7555</i>	<i>17.4</i>	<i>17.4</i>	<i>85.8</i>
	<i>2024</i>	<i>6175</i>	<i>14.2</i>	<i>14.2</i>	<i>100.0</i>
	<i>Total</i>	<i>43378</i>	<i>100.0</i>	<i>100.0</i>	

Table 4 presents descriptive statistics for all variables used in the analysis. The sample comprises of 43,378 firm-level observations. The dependent variable, foreign direct investment (FDI), is a binary indicator equal to one if the firm has any foreign ownership and zero otherwise.

Approximately 18 percent of firms have foreign ownership. Key country-level explanatory variables include corruption, political stability, and democracy. Corruption and political stability are standardized indices, with means of 0.33 and 0.40, respectively, and substantial dispersion across observations. Democracy is measured on a continuous scale, with a mean of 7.25 and moderate variation.

Firm-level controls include firm size, exporter status, firm age, sector affiliation, and perceived corruption as an obstacle. The average firm size is 3.43, and approximately 36 percent of firms engage in international trade. Firms are evenly distributed across sectors, with 48 percent in manufacturing and 52 percent in services. Corruption as an obstacle is measured on a 0–4 scale, with most firms reporting low to moderate levels. Country-level controls include GDP per capita, trade openness, and a regional indicator identifying European Union membership. The average GDP per capita (log) is 9.82, and trade openness averages 100.79 percent. The **Region indicator (Y3)** variable classifies firms into three groups: Western Balkan (5,789 observations), Latin America (5,637 observations), and the European Union (31,952 observations). The sample distribution is heavily skewed towards EU countries, which account for the majority of observations. This imbalance suggests that regional heterogeneity may systematically influence firm-level outcomes, particularly given differences in institutional quality, economic development, and market integration across regions. Overall, the descriptive statistics show meaningful variation across both firm-level and country-level variables, supporting the use of logistic regression models with country and year fixed effects.

Table 4. Descriptive statistics

	<i>N</i>		<i>Mean</i>	<i>Std. Deviation</i>	<i>Percentiles</i>		
	<i>Valid</i>	<i>Missing</i>			<i>25</i>	<i>50</i>	<i>75</i>
<i>FDI</i>	43378	0	0.18	0.381	0.00	0.00	0.00
<i>0 Without foreing ownership 35740</i>							
<i>1 Has any foreing ownership 7638</i>							
<i>Corruption</i>	35401	7977	0.3287	0.73141	-0.2369	0.1877	0.7154
<i>Political_stability</i>	35401	7977	0.3980	0.48433	0.1791	0.5446	0.7258
<i>Democracy</i>	37399	5979	7.2514	1.00724	6.6200	7.3800	7.9600

<i>X1 Firm size</i>	43160	218	3.4334	1.31568	2.4069	3.1959	4.3707
<i>X2 Exporter status</i>	43378	0	0.36	0.479	0.00	0.00	1.00
<i>0 Without engages in international trade</i> 27845							
<i>1 Engages in international trade</i> 15533							
<i>X3 Firm age</i>	42933	445	7.2529	1.38608	7.5995	7.6039	7.6079
<i>X4 Sector</i>	43378	0	0.52	0.500	0.00	1.00	1.00
<i>0 Manufacturing</i> 20873							
<i>1 Services</i> 22505							
<i>X5 Corruption obstracle</i>	43378	0	1.20	1.392	0.00	1.00	2.00
<i>category 0</i> 20962							
<i>category 1</i> 6544							
<i>category 2</i> 6395							
<i>category 3</i> 5387							
<i>category 4</i> 4090							
<i>Y1 GDP per capita</i>	43378	0	9.8186	0.69344	9.2469	9.7582	10.3353
<i>Y2 Trade openness</i>	43378	0	100.7923	43.26776	70.3050	87.9312	125.0300
<i>Y3 Region indicator</i>	43378	0	0.74	0.440	0.00	1.00	1.00
<i>0 Western Balkan</i> 5789							
<i>1 Latin America</i> 5637							
<i>2 EU</i> 31952							

Notes: Categorical variables are represented with category frequency while interval variables are represented by mean, standard deviation and quartiles.

4. EMPIRICAL RESULTS

The following sections present logistic regression results that formally test the study's hypotheses on the impact of corruption, political stability, and democracy on the likelihood of firm-level FDI. These analyses include both firm-level (micro) characteristics such as firm size, age, sector, and export status and country-level (macro) controls including GDP per capita, trade openness, and regional membership while accounting for unobserved heterogeneity through year and country fixed effects. By combining micro and macro-level factors, the models provide a nuanced understanding of how institutional quality interacts with firm-specific attributes to shape foreign investment patterns across countries and regions.

Table 5 presents Spearman's rank correlations among firm-level FDI, institutional variables, and key firm- and country-level controls. FDI is positively correlated with firm size ($\rho = 0.175$, $p < 0.01$) and exporter status ($\rho = 0.262$, $p < 0.01$), suggesting that larger and internationally active firms are more likely to attract foreign investment. FDI shows a weak but significant positive correlation with corruption ($\rho = 0.086$, $p < 0.01$) and democracy ($\rho = 0.095$, $p < 0.01$), while political stability is also positively related but smaller in magnitude ($\rho = 0.035$, $p < 0.01$), consistent with the regression results indicating that the direct effect of corruption is context-dependent. Older firms tend to have lower FDI participation ($\rho = -0.186$, $p < 0.01$), and firms in the services sector show slightly lower foreign ownership than manufacturing firms ($\rho = -0.078$, $p < 0.01$).

Among country-level variables, corruption is strongly positively correlated with democracy ($\rho = 0.850$, $p < 0.01$) and GDP per capita ($\rho = 0.763$, $p < 0.01$), indicating that wealthier and more democratic countries generally experience lower perceived corruption. Political stability is positively correlated with democracy ($\rho = 0.568$, $p < 0.01$) and GDP per capita ($\rho = 0.532$, $p < 0.01$), supporting the view that stronger institutions tend to cluster together. Notably, the "Corruption obstacle" index is negatively correlated with FDI ($\rho = -0.004$, ns), suggesting that perceived bureaucratic corruption obstacles have minimal direct association with firm-level FDI, aligning with the logistic regression results where the effect of corruption becomes statistically insignificant once democracy and political stability are accounted for.

Overall, the correlation matrix provides preliminary evidence of both expected and nuanced relationships: firm characteristics and institutional quality are important for FDI, but the magnitude and direction of these relationships depend on the broader governance context. This confirms the importance of controlling for multiple institutional and macro variables in the regression analysis.

Table 5. Spearman correlation matrix

	<i>FDI</i>	<i>Corruption</i>	<i>Political stability</i>	<i>Democracy</i>	<i>X1 Firm size</i>	<i>X2 Exporter status</i>	<i>X3 Firm age</i>	<i>X4 Sector</i>	<i>X5 Corruption obstacle</i>	<i>Y1 GDP per capita</i>	<i>Y2 Trade openness</i>	<i>Y3 Region indicator</i>
<i>FDI</i>	1.000	0.086**	0.035**	0.095**	0.175**	0.262**	0.186**	0.078**	-0.004	0.083**	-0.048**	0.014**
<i>Corruption</i>	0.086**	1.000	0.690**	0.850**	0.064**	0.145**	0.142**	0.028**	-0.264**	0.763**	0.058**	0.574**
<i>Political stability</i>	0.035**	0.690**	1.000	0.568**	0.067**	0.086**	0.019**	0.018**	-0.251**	0.532**	0.441**	0.634**
<i>Democracy</i>	0.095**	0.850**	0.568**	1.000	0.011*	0.158**	0.193**	0.003	-0.178**	0.825**	-0.103**	0.540**
<i>X1 Firm size</i>	0.175**	-0.064**	-0.067**	-0.011*	1.000	0.256**	0.202**	0.183**	0.027**	0.024**	-0.068**	-0.047**

<i>X2 Exporter status</i>	-0.262**	0.145**	0.086**	0.158**	0.256**	1.000	-0.159**	-0.246**	-0.046**	0.180**	0.052**	0.130**
<i>X3 Firm age</i>	-0.186**	-0.142**	-0.019**	-0.193**	0.202**	-0.159**	1.000	0.129**	-0.032**	0.091**	0.196**	0.027**
<i>X4 Sector</i>	-0.078**	-0.028**	0.018**	0.003	0.183**	-0.246**	0.129**	1.000	-0.043**	0.033**	0.166**	0.070**
<i>X5 Corruption obstacle</i>	-0.004	-0.264**	-0.251**	-0.178**	0.027**	-0.046**	-0.032**	-0.043**	1.000	0.241**	-0.244**	-0.217**
<i>Y1 GDP per capita</i>	0.083**	0.763**	0.532**	0.825**	0.024**	0.180**	-0.091**	0.033**	-0.241**	1.000	0.120**	0.683**
<i>Y2 Trade openness</i>	-0.048**	0.058**	0.441**	-0.103**	0.068**	0.052**	0.196**	0.166**	-0.244**	0.120*	1.000	0.337**

Notes: Values in matrix represent Spearman's rho coefficients; **. *Correlation is significant at the 0.01 level (2-tailed)*; *. *Correlation is significant at the 0.05 level (2-tailed)*

To test the first hypothesis (H1) that higher levels of country-level corruption reduce firm-level FDI, we estimate logistic regression models including firm- and country-level controls with year and country fixed effects. The variable of interest, Corruption_{i,t} is measured using the Control of Corruption index from the Worldwide Governance Indicators (WGI), which captures perceptions of public-sector corruption on a standardized scale. Higher values indicate stronger control of corruption, while lower values reflect greater perceived corruption. In both the **full sample** and the **EU countries**, higher perceived corruption (lower WGI scores) is associated with a higher likelihood of firm-level FDI (full sample: coefficient = 0.870, OR = 2.387, $p < 0.01$; EU: coefficient = 0.789, OR = 2.202, $p < 0.01$). This counterintuitive result suggests that in these contexts, firms may be able to navigate or manage the challenges of corruption, so it does not act as a strong deterrent to foreign investment.

In contrast, in **Latin America**, corruption has a small but statistically significant negative effect (coefficient = -0.267, OR = 0.766, $p < 0.01$), indicating that weaker institutional integrity reduces the likelihood of FDI in this region. In the **Western Balkans**, the effect of corruption is negative but not statistically significant (coefficient = -0.128, OR = 0.880, $p > 0.05$), consistent with the expectation that corruption may act as a barrier, though the effect is not robust.

Overall, these findings demonstrate that the effect of corruption on firm-level FDI is **highly context-dependent**. While corruption appears manageable or less deterrent in the EU and the pooled sample, it significantly constrains investment in Latin America, highlighting the importance of regional governance conditions and firms' capacity to operate effectively in environments with varying institutional quality.

Table 6. Logistic Regression of FDI on Corruption with Firm- and Country-Level Control

Variable	(1) All Countries			(2) EU Countries			(3) Western Balkan Countries			(4) Latin America Countries		
	Coefficient	Std. Error	Odds ratio	Coefficient	Std. Error	Odds ratio	Coefficient	Std. Error	Odds ratio	Coefficient	Std. Error	Odds ratio
Constant	15.998** *	3.997	8.E+6	18.036** *	5.048	6.E+7	56.384** *	18.284	3.E+24	- 32.614** *	3.882	0.000
Corruption	0.870***	0.194	2.387	0.789***	0.250	2.202	-0.128	0.514	0.880	- 0.267***	0.069	0.766
X ₁ Firm size	0.481***	0.013	1.617	0.454***	0.016	1.575	0.577***	0.036	1.781	0.678***	0.042	1.970
X ₂ Exporter status	1.050***	0.040	2.857	1.052***	0.046	2.865	0.655***	0.105	1.924	1.210***	0.136	3.355
X ₃ Firm age	- 0.349***	0.012	0.706	- 0.517***	0.017	0.597	-0.111	0.058	0.895	- 0.060***	0.023	0.942
X ₄ Sector	-0.012	0.038	0.988	-0.031	0.045	0.969	0.138	0.104	1.148	-0.207	0.127	0.813
X ₅ Corruption obstacle	- 0.052***	0.015	0.950	- 0.075***	0.018	0.928	-0.009	0.036	0.991	0.021	0.045	1.021
Y ₁ GDP per capita	- 1.913***	0.419	0.148	- 1.714***	0.475	0.180	- 6.214***	1.917	0.002	2.957***	0.399	19.235
Y ₂ Trade openness	0.002	0.003	1.002	0.007*	0.004	1.007	- 0.024***	0.008	0.976	(a)		
Y ₃ Region indicator(1)	1.050	0.266	2.857									
Y ₃ Region indicator(2)	3.366***	0.639	28.951									
Year FIXED EFFECTS	YES			YES			YES			YES		
Country FIXED EFFECTS	YES			YES			YES			YES		
N	34957			26034			5254			3669		
Nagelkerke R Square	0.282			0.325			0.160			0.268		

Notes: Year and Country fixed effects are included in the estimations, but they are not reported.

*, **, *** Indicate statistical significance at the 0.10, 0.05, and 0.01 levels, respectively. All tests are based on two-tailed Wald test.

^a Variable excluded from analysis due to redundancies.

Table 7. Logistic regression of firm-level FDI on Corruption, Political Stability, and Democracy, controlling for firm- and country-level characteristics, with Year and Country fixed effects

Variable	(1) All Countries			(2) EU Countries			(3) Western Balkan Countries			(4) Latin America Countries		
	Coefficient	Std. Error	Odds ratio	Coefficient	Std. Error	Odds ratio	Coefficient	Std. Error	Odds ratio	Coefficient	Std. Error	Odds ratio
Constant	17.197* *	7.804	2.E+7	19.127	12.475	2.E+8	55.636	31.603	1.E+24	-4.332** *	0.271	0.013
Corruption	-0.090	0.291	0.914	-0.415	0.417	0.660	-0.578	0.610	0.561	-1.659** *	0.204	0.190
Political stability	-0.196	0.287	0.822	-0.048	0.402	0.954	-1.931** *	0.667	0.145	2.419** *	0.325	11.152
Democracy	0.328* *	0.187	1.389	0.574	0.303	1.776	-0.006	0.419	0.994	(a)		
X ₁ Firm size	0.481** *	0.015	1.618	0.464** *	0.017	1.590	0.575** *	0.042	1.777	0.679** *	0.042	1.970
X ₂ Exporter status	1.065** *	0.043	2.901	1.029** *	0.050	2.797	0.724** *	0.122	2.063	1.210** *	0.136	3.355
X ₃ Firm age	-0.376** *	0.013	0.687	-0.597** *	0.019	0.550	-0.055	0.084	0.946	-0.060** *	0.023	0.942
X ₄ Sector	-0.047	0.042	0.954	-0.068	0.049	0.934	0.161	0.121	1.174	-0.207	0.127	0.813
X ₅ Corruption obstacle	-0.053** *	0.016	0.948	-0.078** *	0.020	0.925	-0.016	0.043	0.985	0.021	0.045	1.021
Y ₁ GDP per capita	-2.183** *	0.755	0.113	-1.958** *	0.985	0.141	-6.561** *	3.327	0.001	(a)		
Y ₂ Trade openness	-0.007	0.005	0.993	-0.004	0.008	0.996	0.005	0.017	1.005	(a)		
Y ₃ Region indicator (1)	0.441	0.429	1.557									
Y ₃ Region indicator (2)	5.128** *	1.313	168.621									
Year FIXED EFFECTS	YES			YES			YES			YES		
Country FIXED EFFECTS	YES			YES			YES			YES		

N	30832	23135	4028	3669
Nagelkerke R Square	0.301	0.353	0.158	0.268

Notes: Year and Country fixed effects are included in the estimations, but they are not reported.

*, **, *** Indicate statistical significance at the 0.10, 0.05, and 0.01 levels, respectively. All tests are based on two-tailed Wald test.

^a Variable excluded from analysis due to redundancies.

Hypothesis 2 (H2) posited that higher political stability has a positive effect on firm-level FDI. When political stability is included in the regression alongside corruption and other control variables, the direct effect of corruption becomes statistically insignificant in both the full sample and the EU subsample (full sample: coefficient = -0.090 , OR = 0.914 , $p > 0.05$; EU: -0.415 , OR = 0.660 , $p > 0.05$), suggesting that the detrimental impact of corruption on FDI is reduced in more stable political environments. However, in Latin America, corruption remains strongly negative and statistically significant (coefficient = -1.659 , OR = 0.190 , $p < 0.01$), indicating that weak institutional integrity continues to substantially deter foreign investors in this region. In the Western Balkan countries, political stability shows a negative and statistically significant coefficient (coefficient = -1.931 , OR = 0.145 , $p < 0.01$), indicating that higher levels of stability are associated with a lower probability of foreign ownership. This counterintuitive result may reflect region-specific dynamics, such as foreign investment driven by privatization waves, restructuring processes, or risk-tolerant investors operating in less stable environments. In contrast, political stability has a strong positive and statistically significant effect in Latin America (coefficient = 2.419 , OR = 11.152 , $p < 0.01$), suggesting that stable political environments substantially increase the likelihood of foreign ownership. These findings suggest that political stability can buffer the negative consequences of corruption on FDI, particularly in countries where instability is a major concern, confirming the context-dependent nature of H2.

To test the third hypothesis (H3), which proposes that higher levels of democracy are associated with higher firm-level FDI, we examine the joint effects of corruption, political stability, and democracy on FDI, controlling for firm- and country-level characteristics with year and country fixed effects (Table 7). In the full sample, once democracy is included, the coefficient on corruption becomes small and statistically insignificant (coefficient = -0.090 , odds ratio = 0.914), suggesting that higher levels of democracy moderate the potential negative impact of corruption on FDI. A similar pattern is observed for EU countries, where corruption is also not significant (coefficient = -0.415 , odds ratio = 0.660), while the democracy variable shows a positive and marginally significant effect on FDI (coefficient = 0.574 , odds ratio = 1.776 , $p < 0.10$). In the Western Balkan countries, democracy has no statistically significant effect (coefficient = -0.006 , odds ratio = 0.994), and corruption is likewise insignificant. Thus, H3 is not supported in this regional context. For Latin America, democracy is not estimated in the model due to specification constraints (as indicated in Table 7), while corruption remains strongly negative

and significant. These results provide limited support for H3, as democratic institutions strengthen, the adverse effects of corruption on foreign investment appear to be moderated, suggesting that firms are better able to operate in countries with higher democratic quality even when some corruption is present. Democracy appears to exert a positive effect on firm-level FDI in the full sample, but this relationship weakens or disappears in regional subsamples. Importantly, although corruption becomes insignificant in several specifications once democracy is included, this does not formally demonstrate a moderating effect, as no interaction term between corruption and democracy is modelled. Rather, the findings suggest overlapping institutional influences and substantial regional heterogeneity in the relationship between democratic quality and foreign ownership.

Firm-level characteristics play a central and highly robust role in explaining firm-level FDI across all specifications. Firm size (X1) has a strong positive and statistically significant effect in every sample (full sample: coefficient = 0.481, OR = 1.618, $p < 0.01$; EU: 0.464, OR = 1.590, $p < 0.01$; Western Balkans: 0.575, OR = 1.777, $p < 0.01$; Latin America: 0.679, OR = 1.970, $p < 0.01$). These results indicate that larger firms are consistently more likely to attract foreign ownership, with the magnitude of the effect particularly pronounced in Latin America. Exporter status (X2) is also positive and highly significant across all subsamples (Full sample: 1.065, OR = 2.901, $p < 0.01$; EU: 1.029, OR = 2.797, $p < 0.01$; Western Balkans: 0.724, OR = 2.063, $p < 0.01$; Latin America: 1.210, OR = 3.355, $p < 0.01$). This suggests that firms engaged in international trade are substantially more likely to receive foreign investment, supporting the view that internationally integrated firms are more attractive to foreign investors. In contrast, firm age (X3) shows a negative and statistically significant effect in the full sample and EU countries (Full sample: -0.376 , OR = 0.687, $p < 0.01$; EU: -0.597 , OR = 0.550, $p < 0.01$), indicating that older firms are less likely to have foreign ownership. In the Western Balkans, however, firm age is not statistically significant (-0.055 , OR = 0.946, $p > 0.05$), while in Latin America the effect remains negative and statistically significant, though economically smaller (-0.060 , OR = 0.942, $p < 0.01$). Overall, firm-level characteristics remain the most stable and powerful determinants of foreign ownership across all regional contexts.

Turning to country-level institutional variables, the effect of corruption on firm-level FDI becomes statistically insignificant in both the full sample and the EU countries once political stability and democracy are included in the model (full sample: coefficient = -0.090 , OR = 0.914, $p > 0.05$; EU: -0.415 , OR = 0.660, $p > 0.05$). This suggests that, in relatively stable and democratic contexts, corruption alone does not independently explain foreign ownership. In contrast, corruption remains strongly negative and significant in Latin America (coefficient = -1.659 , OR = 0.190, $p < 0.01$), highlighting that weak institutional integrity continues to deter foreign investment where institutional quality is lower. Political stability shows region-specific effects. It is not significant in the full sample or EU countries (full sample: -0.196 , OR = 0.822, $p > 0.05$; EU: -0.048 , OR = 0.954, $p > 0.05$), likely reflecting relatively high baseline stability. In the Western Balkans, however, political stability has a negative and statistically significant

coefficient (-1.931 , $OR = 0.145$, $p < 0.01$), suggesting that higher stability is unexpectedly associated with lower FDI, which may reflect region-specific investment dynamics such as privatization-driven inflows or risk-tolerant investors in transitional economies. Conversely, in Latin America, political stability is strongly positive and significant (2.419 , $OR = 11.152$, $p < 0.01$), indicating that stable political environments substantially increase the likelihood of foreign ownership.

Democracy shows a positive and weakly significant effect in the full sample (0.328 , $OR = 1.389$, $p < 0.10$), while its impact is not statistically significant in the EU (0.574 , $OR = 1.776$, $p > 0.05$) or Western Balkans (-0.006 , $OR = 0.994$, $p > 0.05$). These findings suggest that the quality of democratic institutions may support foreign investment in diverse contexts but depends on the region. Overall, the results highlight that institutional quality is important for firm-level FDI, but the specific effects of corruption, political stability, and democracy differ across regions. In stable and democratic settings, corruption alone does not significantly deter foreign ownership, whereas in less stable or weaker institutional environments, political stability and governance quality are the main factors influencing foreign investment.

5. LIMITATIONS OF THE STUDY

One of the main limitations of this study arises from the structure of the panel data used in the analysis. A fully balanced panel would require complete observations for all countries in all years of the study period. However, the dataset used in this research is highly unbalanced, mainly due to the unavailability of data in existing databases for certain countries and years. For example, as shown in Table 1, although the observation period covers nine years for the selected countries, some countries such as Brazil have data for only a single year- and lack data for the remaining eight years. Similar gaps are present for Austria, Belgium, Chile, and several other countries. The high degree of panel unbalancedness is a significant limitation, potentially reducing the reliability and generalizability of the results. Missing observations may affect coefficient estimates and the precision of inferences, particularly when analyzing country-level institutional effects on firm-level FDI.

Given the current limitations in available data, constructing a fully balanced panel is not feasible. However, as databases are updated and data coverage improves, future studies could leverage more complete longitudinal data to enhance the robustness of the analysis. Balanced panels in future studies would allow for more robust testing of the hypotheses and would likely improve the validity of the results. In such a dataset, we expect that the first hypothesis, in particular, could be confirmed with greater confidence.

CONCLUSION

The relationship between corruption and foreign direct investment (FDI) remains one of the most debated and empirically explored topics in international business and development economics. The evidence gathered across firm-level and country-level analyses reveals that corruption plays a dual role, functioning both as a barrier and, in specific institutional contexts, as a catalyst for investment. While some authors support the argument that corruption may ease bureaucratic obstacles in rigid regulatory systems, the majority of empirical findings suggest that corruption primarily distorts market mechanisms, increases transaction costs, and reduces investor confidence.

This study investigates the determinants of firm-level foreign direct investment (FDI) across 31 countries using a large unbalanced panel dataset of 43,378 observations from selected years between 2009 and 2024. Our results highlight the interplay between firm characteristics and country-level institutions in shaping FDI patterns. At the firm level, larger firms and exporters are significantly more likely to attract foreign investment, while older firms are slightly less likely to receive FDI. At the country level, the direct effect of corruption on FDI is context-dependent: in the full sample and among EU countries, higher perceived corruption is associated with increased foreign ownership, suggesting that firms may be able to navigate institutional weaknesses. However, once political stability and democracy are included, corruption becomes statistically insignificant in the full sample and EU countries, indicating that in relatively stable and democratic environments, corruption alone does not independently reduce foreign investment. Political stability shows region-specific effects: it is not significant in the full sample or EU countries, is negatively and significantly associated with FDI in the Western Balkans (-1.931 , $OR = 0.145$, $p < 0.01$), and is strongly positive and significant in Latin America (2.419 , $OR = 11.152$, $p < 0.01$), highlighting that its influence on foreign ownership depends on regional context. Democracy exhibits a positive and weakly significant effect in the full sample (0.328 , $OR = 1.389$, $p < 0.10$) but is not significant in the EU or Western Balkans, suggesting that democratic institutions may support FDI in heterogeneous environments, but their impact is region-dependent rather than uniform.

These findings carry important implications for both policymakers and multinational firms. For governments, strengthening democratic institutions and ensuring political stability can reduce the detrimental effects of corruption on FDI and create a more predictable investment climate. For firms, the results underscore the importance of firm-specific capabilities, such as size and international engagement, in navigating different institutional contexts. Overall, this study demonstrates that the relationship between corruption and FDI cannot be understood in isolation: the interaction between institutional quality, political stability, and democracy plays a critical role in shaping foreign investment flows. By combining firm-level micro data with country-level macro indicators, this analysis provides a nuanced, context-sensitive understanding of how

foreign investors respond to institutional environments, offering both theoretical insights and practical guidance for attracting FDI in diverse governance settings.

In conclusion, corruption remains one of the most critical institutional determinants of FDI, but its impact is mediated by political and democratic contexts. While firm-level resilience and adaptability play a role in mitigating risks, the broader institutional environment ultimately determines the extent to which corruption deters or permits investment. The comparative evidence between European and non-European countries underscores that corruption's effect is not only economic but also deeply political and institutional. Therefore, sustainable investment attraction requires not only reducing corruption but also strengthening the institutional foundations that promote trust, transparency, and fair competition.

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